Congressman Tom Feeney Testimony
House Government Reform Committee
SUBCOMMITTEE ON REGULATORY AFFAIRS
"The Sarbanes-Oxley Act 4 years later: What have we Learned?"
April 5, 2006

Madame Chairman, Ranking Member Lynch and members of the Subcommittee, thank you for inviting me to testify today. I am Congressman Tom Feeney from the 24th District in Florida. I serve on the House Committees on Judiciary and Science as well as the House Committee on Financial Services which has jurisdiction over the Sarbanes-Oxley Act.

In July 2002, as a reaction to corporate scandals such as the Enron and WorldCom collapses, Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002, otherwise known as the Sarbanes-Oxley Act (SOX). SOX is said to be the most comprehensive and important corporate governance reform since Franklin Delano Roosevelt was in office. I was not a Member of Congress when this legislation was passed and signed into law. I was therefore surprised when members of the business community requested meeting after meeting to express their concern and down right panic about the perceived compliance costs of SOX. However, in my line of work I do understand that panic may sometimes be a result of a lack of the facts. I like to say that Congress only has two gears- "fail to act" and "overreact." I did not want to overreact to the concerns being laid out before me. So to further understand the Sarbanes-Oxley Act and the issues surrounding it, last year we--a bipartisan group of House colleagues--formed a coalition to participate in roundtables and listening sessions attended by leaders from business, academia, and the policy community. Our goal was to assess the cost versus the benefits of the Sarbanes-Oxley Act.

I have concluded thus far from my listening tour participation that there is general agreement that after SOX was passed, financial reporting is tighter, internal controls have improved, and that there is more transparency in the over all auditing process. SOX supporters cite that increased investor confidence has been a result of this increased transparency. In a March 6, 2006 speech given by James Turley, Chairman and CEO of

Ernst and Young, he states, "Sarbanes-Oxley and all of the other changes that have taken place are helping to restore public trust." He goes on to say "Now, I'm not suggesting that the Sarbanes-Oxley Act or any single action is behind these numbers. But they do clearly suggest that investor confidence and the resultant market activity have strengthened, and not in just a small way." Was the SOX legislation necessary or could it be that companies began to take a closer look at their internal controls after the accounting scandals of Enron and WorldCom? One common theme that I continued to hear during the listening tour was that you can not legislate morality and that SOX has punished the "good guys" because the "run-of-the-mill" fraud that was perpetrated upon investors of certain companies. However, they do concede that prior to SOX their internal controls needed to be sharpened and they feel as though they have done that from within. Many participants believe that external audits are redundant and therefore too costly and will do nothing to stop the "bad guys" from breaking the law.

We have also heard repeatedly that due to liabilities and potential penalties, these external auditors typically leave no stone unturned, making audits costly and time consuming for all businesses and unaffordable for small and medium sized businesses that are trying to compete in the global marketplace.

On January 6, 2006, the Wall Street Journal pointed out in an article titled "New York Loses Edge in Snagging Foreign Listings" that in 2000 "nine out of every 10 dollars raised by foreign companies through new stock offerings were done in New York rather than London or Luxembourg -- the two other main choices for listings like these -- according to data from Citigroup.

But by 2005, the reverse was true: Nine of every 10 dollars were raised through new company listings in London or Luxembourg, the biggest spread favoring London since 1990." This was a startling number to me. In fact, the day after I cited the number from the Wall Street Journal I received the following email from one of my constituents:

"I was part of a venture capital panel and the moderator, a prominent attorney in Silicon Valley, said that the senior management of the London Stock Exchange and its AIM (alternative

investment market) "felt guilty every time they visited Washington DC and didn't bring chocolates and flowers for Sarbanes and Oxley."

After a recent trip to Hong Kong, I received very similar feedback regarding SOX from their Chief Financial Officer, Mr. Tung. Mr. Tung practically thanked me and my colleague for SOX and the competitive advantage it gives the Hong Kong market. The Financial Times stated in November 2005, "Over the past few years, as more global investors have begun to invest in Asia, the New York Stock exchange appears to have lost its allure for the region's leading companies...The roots of New York's recent difficulties in winning Asian companies' listing lies in the high burden of regulations and compliance.

Many [listening tour] participants also noted that a focus on the dollar cost of [Section] 404 compliance ignores the indirect costs such as employee time and executive expertise that must be directed away from day-to-day business operations to comply with the new auditing requirements. This is a huge opportunity cost. A paper by Henry Butler of Chapman University and AEI-Brookings Joint Center for Regulatory Studies and Larry Ribstein of the University of Illinois School of Law cites the "direct compliance costs of SOX are about $6 billion per year, but this expense (which basically represents payments to accountants) is a small fraction of the total compliance costs for firms. The indirect costs from having to divert company resources are much greater and based on a back-of-the-envelope calculation of how SOX impacted American markets, they can be estimated at about $1.1 trillion." That is trillion with a T. As Sun Microsystems CEO Scott McNealy said of Sarbanes-Oxley it's like "throwing buckets of sand into the gears of the market economy." Listening tour participants complained that when facing these regulatory burdens in America they have two choices: go private or move overseas. For example, the Independent Community Bankers of America provided me with a spreadsheet as of December 6, 2005 identifying 75 community banks that have filed with the SEC to go private since January 1, 2003. Another example is the Vermont Teddy Bear Company that recently decided to go private. Elisabeth B. Robert, the Chief Executive in a May statement, referring to the Rule 404 work mandated by Sarbanes-Oxley said "As a private company, Vermont Teddy Bear will no longer face the challenges of a company trying to comply with increasingly complex and costly public company requirements." In a survey

of 147 public companies, Foley & Lardner, the New York law firm, found that 20% of respondents said they were considering going private, up from 13% in 2003. Statistics like these make me very concerned about investor opportunity. Fewer smaller firms in the market place have the potential of creating an investor class that is only able to invest in larger companies instead of investing in smaller companies with great growth potential. How different would the world be if Microsoft or Dell had decided not to go public or would have decided to go private after they reached a certain market cap to avoid complying with Sarbanes-Oxley? Those investors would have lost out on the great opportunity for wealth that they were able to be a part of.

Another issue of concern that has been brought to my attention is the impact of SOX on research and development. The Biotechnology Industry Organization was able to provide me with many examples like Mayland Biotech Company-a private company that utilizes blood cells to create drugs. Mayland Biotech has spent the last 12-18 months becoming SOX compliant. They estimate that the cost of ramping up for 404 is equal to 6-7 months of R&D costs. Another example is the New York Biotech Company-a public company with a market cap of $99M. New York Biotech has 65 employees and mainly focuses their work on spinal cord injury. They spend $4M for Clinical trial and R&D- for a possible product to cure spinal cord injuries. They have estimated that they spent $1 million on SOX compliance. That is 25% of their yearly budget.

In a letter addressed to the Securities and Exchange Commission's Office of the Small Business Policy Division of the Corporation Finance dated March 7, 2006, Grant Thornton states that "Section 404 requirements are not the source of the problem. The root cause is the lack of guidance for good internal controls that are applicable in myriad business situations." Contrary to Grant Thorton's take on Section 404, William McDonough, who retired early from his post as chairman of the Public Company Accounting Oversight Board (PCAOB) stated in a Wall Street Journal interview on Oct. 12, 2005:

> **"In many cases, it's clear that they [auditors] overdid it. There's no question that some auditors got it right on; there are other cases, in fact probably more, in which the auditors overdid it, and decided we better check**

> **everything under sun. Why? Because [they're] also concerned about being sued. Now, in the process, we think that because of the guidance we've given on the implementation of 404 … that auditors are doing a better job in the second year. It's also perfectly clear to us that they've got a lot of room for additional improvement."**
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> **"But in general, the reason that we are beating the drum so much on trying to make 404 more cost effective, is that it is inappropriate for the well-being of the American people if companies have costs which simply don't have any appropriate offsetting benefit."**

As Mr. Butler and Mr. Ribstein put it, "the immense costs of compliance have become apparent and business leaders question whether the act's supposed benefits actually represent any real gain over the previous era." The intent behind SOX was complete investor protection from fraud. However in the day and age of the internet and E*Trade, I am able to get online at any hour of the day and invest in any penny stock in Shanghai or anywhere else in the world. Unless Congress is going to police the capital markets of the world then I believe that capital will continue to flow toward less regulation.

I believe it is time to review the effects of Sarbanes-Oxley, keep what which is a net advantage to investors, and reform or eliminate those provisions that are a net disadvantage to investors.

Madame Chairman I will close out my testimony by saying this-it has become obvious to me after participating in the listening tour that this is not an issue that Congress can continue to ignore and it will just work itself out. Sarbanes-Oxley clarification is vital to keeping America's markets the best and strongest in the world. It has been an honor to testify before my distinguished colleagues. Again, thank you for inviting me.